School for Traders & Investors

Seventh Lesson

Points on Short Selling

THE Ryan attempt to corner Stutz and the Saunders' failure to corner Piggly-Wiggly, should prove to everybody that there is no money in corners for either side. Any one undertaking to corner a stock runs the risk of "holding the bag" and having no one on whom to unload. Those who sell a stock short, and are cornered or nearly so, realize by this time that tremendous losses can be suffered by letting a stock run against one without any effort to limit the risk.

We suppose that the fear of being cornered has more to do with the reluctance of the public to sell stocks short than any other single factor; but when we come to count the corners of the past several years, we find that there is about one chance in a million that a person will be so caught, and even this one chance can be eliminated by limiting the risk to two, three, five or ten points on any short trade that is undertaken. Not to take this precaution, but to leave the way open for a large loss, is a form of financial suicide which we hope none of our students will ever commit. They can avoid this by placing a stop order *at the same time* they sell a stock short. Failure to do this is like buying a house and putting no fire insurance on it.

We will discuss stop orders and their advantages in another lesson; meanwhile we will confine ourselves today to the subject of short selling.

THIS article was written in response to the demand of a number of subscribers that we explain the part the short seller plays in the market. Of course, we could have said a great deal more than is included in these columns (volumes could be written on the subject). The main attempt, however, has been merely to describe the function of short-selling in a practical way, so as to present its broadest general aspect. Subsequent installments of the School for Traders & Investors will deal more at length with this subject.

Speed of a Bear Market

As the average bull market lasts two years and the average bear market one year, making a complete cycle of about three years, it will be seen that the market travels downward twice as rapidly as it moves upward; therefore the man who sells short at the top and is clever enough to cover at the bottom makes as much in one year as the so called long-pull operator can realize in two years if he buys at the bottom and sells at the top.

Notwithstanding the legitimacy and the practical necessity of short selling, many people look upon the bears as enemies of the Republic in general and of the holders of long stocks in particular. In the panic of 1907, there was a great outcry against short selling, which resulted in the appointment by Governor (now Secretary of State) Hughes of a committee to investigate all the operations of the New York Stock Exchange. Part of this committee's report relating to this point is included in the following:

"We have been strongly urged to advise the prohibition or limitation of short sales, not only on the theory that it is wrong to agree to sell what one does not possess, but that such sales reduce the market price of the securities involved. We do not think that it is wrong to agree to sell something that one does not now possess, but expects to obtain later. Contracts and agreements to sell, and deliver in the future, property which one does not possess at the time of the contract, are common in all kinds of business. The man who has "sold short" must some day buy in order to return the stock which he has borrowed to make the short sale. Short-sellers endeavor to select times when prices seem high in order to sell, and times when prices seem low in order to buy, their action in both cases serving to lessen advances and diminish declines of price. In other words, short selling tends to produce steadiness in prices, which is an advantage to the community. No other means of restraining unwarranted marking up and down of prices has been suggested to us."

The Part the Short Seller Plays

From this it will be seen that the short seller plays a very important part in making a broad and stabilized market. The bear is really the friend of the bull. Very often, when the bull wants to sell out there would be no one there to buy from him were it not for the bears who are so deprecated by people who do not understand. A short seller is a potential buyer; he can close his trades only by purchasing, and in so doing he supports the market, in fact, helps to create the demand. If he is clever enough to sense weakness in the market when it is at high levels and looking top-heavy, he is entitled to the reward he gets in the way of profits on short sales. We mention these facts in order that our students may realize that there are two sides to the market and that the short side is just as legitimate as the long side, and if they are to be good traders and speculators they must banish the prejudice which has doubtless grown up in the minds of many of them and remould their ideas to conform to the true facts.

There is another reason why the short side should be favored: It is a well-known fact that the public almost invariably operates on the long side, does most of its buying when stocks are strong and high, and acts as a foil to the professional operator and floor trader. The latter classes know how to take advantage of the short side, and most of the people to whom they sell at the top and from whom they buy at the low prices, are members of that big public who refuse to see the bear side.

The Action of Stewart-Warner

One of the most interesting illustrations of the way in which a stock can become overbought and decline heavily because short interest is lacking, is found in the recent action of Stewart-Warner. Any one who doubts the value of studying the technical position of a stock should be entirely cured by looking into this episode.

In the summer of 1921 Stewart-Warner sold at 21. In March and April, 1922, it worked up to around 35. By June it was 45. In October it touched 53; in November, 60; December, 79. The early part of 1923 marked an almost uninterrupted rise until in March it sold at 123, and in April at 124, or over 100 points in a year and a half—an appreciation of 500%.

The news items which accompanied this rise showed that in 1920 the company earned $4.83 a share; in August, 1921, the business was reported to be going along nicely, its earnings running at the annual rate of about $2.75 a share. For the September quarter, net profits were at an even lower rate. In May, 1922, earnings were reported to be running at about $4 per share. For the half year they equaled nearly $8 per annum, the dividend having

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been raised in April to a $3 rate. In October, the dividend was raised to a $4 basis. In November, an extra dividend of $1 a share was declared. In January, this year, earnings were at the rate of $11 per share, and the dividend rate was raised to $6 per annum.

Enthusiasts on the stock claimed that, while book value was only $49.50 a share, the earning power of the company was very large. Two million dollars of 8% convertible bonds were paid off four years in advance, leaving no funded debt, bank loans, or other indebtedness outside of current bills.

At the height of the bull fever in March and April, this year, the earnings were supposed to be running at about $16 per share. I guess everybody in Chicago, Detroit, and other automobile centers had some Stewart-Warner. There was evidently "no limit to the earning power, nor the high price at which the stock was likely to sell." With automobile production going on at terrific pace, and the demand for speedometers and other accessories outstripping all previous records, there was no trade reason why any one should get bearish.

And that was just the trouble.

Any market which is completely monopolized by the bulls is in a highly unhealthy condition, for a good-sized short interest is absolutely necessary for the protection of the market in any active speculative stock. The position of Stewart-Warner was a good deal like that of an excursion steamer on which the passengers are all suddenly attracted to one side of the boat. The steamer tips over sideways. That is what Stewart-Warner did. A lot of people wanted to get out at the same time.

On Monday, April 30th, the stock opened at 117½, which was ex dividend 2½%. The following 600 shares resulted in a decline to 114, as follows:

100 ......117½
200 117
100 ......116½
100 ......116¾
100 114

It rallied to 116½, but the closing transactions of that day were:

100 115
100 114
500 ......113½

During the afternoon of May 1st this was what happened:

500 113
100 112
100 112
100 113
300 112
100 ......112¼
200 ......111½
200 112
200 ......111½
700 ......111¼
100 111
100 ......110½
200 110
100 ......109¾
100 110
100 ......109¼
400 109
100 ......107⅞
100 ......107½
300 106

The stock closed on May 3rd at 104¼. Part of the transactions on May 4th, which resulted in a decline of over 14 points from the previous day's close, were as follows:

1000 .....100¼
200 100
300 ..... 99½
200 100
100 99
900 98
100 ..... 97½
100 98
700 97
300 98
200 ..... 97½
200 ..... 97¼
100 ..... 97½
200 98
300 ..... 98½
100 ..... 98¼
100 ..... 98¾
200 ..... 98¼
200 98
200 ..... 98¾
1000 98
100 ..... 98¼
100 ..... 97¾
100 ..... 97½
100 98
100 ..... 97½
100 ..... 97¾
100 ..... 97½
100 ..... 97⅞
100 ..... 97¾
100 ..... 97¼
500 ..... 97½
100 ..... 97¼
100 ..... 97½
100 ..... 97¼
100 ..... 97⅛

From 12 M. to 2 P.M.

100 ...... 97⅛
100 ...... 97¼
900 97
100 ...... 96½
400 ...... 96¼
700 96
100 95
100 94
300 91
200 ...... 91½
100 ...... 91¼
200 ...... 90¾
200 ...... 90½

On Saturday, May 5th, the stock closed at 94. Monday morning it opened down 5½ points at 85 (1000 shares), and after fluctuating about that level during the morning, it took another dive after twelve o'clock as follows:

100 85
300 84
300 83
200 82
100 ...... 81½
100 ...... 80¾
100 ...... 80½
100 ...... 80¼
100 ...... 80½

In looking over these transactions we find numerous wide breaks between sales, indicating that there were no close bids. In order to find buyers the stock had to be offered down until someone was willing to take it. For example, on April 30th there were no sales between 116¾ and 114—a gap of 2¾ points. That could scarcely happen to a stock in which there was a fair-sized short interest. On May 4th there were numerous differences of a point between sales.

The Results of Having No Short Interest

Of course, we have not given all the transactions above, but just enough to illustrate our point. We do not know how much of this 40-point decline was due to wise selling, but the majority of the liquidation appears to have come from the public and the wide gaps between sales served to demoralize those who still held the stock, and undoubtedly forced the decline from ten to twenty points lower than it would have gone had there been a satisfactory short interest.

The episode also illustrates how quickly money can be made on the bear side of a stock which is in a weak technical position; when many enthusiastic bulls hold the stock and few people are bearish on it; in other words when the supply is far in excess of the demand. Once such a supply is let loose it has a cumulatively depressing effect upon the shares. Each point decline weakens so many accounts that forced liquidation is the result.

INTIMATE TALKS WITH READERS

Right Viewpoint About Dividends

THERE are few things connected with investment and speculation that lead astray so often, or so far afield as the dividend question.

After all, the main object of speculating should be to make more money, in order to have *more money to invest.* When we invest, we should seek (a) safety of capital invested and (b) assured income that is more likely to increase than to grow smaller.

All this expresses itself in the desire to buy dividend-paying stocks cheaply, or potential dividend payers at bargain prices, not so much because of an expected rise in cheap stocks so much as the possibility of the inauguration of dividends on them, and their graduation to the investment class.

Many people, especially beginners, are real dividend-fans. We'll explain that term in a moment. Their actions in buying "for the dividend" is, to our mind, productive of certain characteristic movements in stocks that we have noticed for a number of years. Such action is so *marked* that it becomes more than a mere coincidence.

Get hold of a long list of dividend-paying stocks, and note the dates they sell "ex dividend," or the dates of their regular declarations. The quarterly disbursements are the most common and more easily followed.

It seems almost uncanny how, at times

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